Daily Comment

Confluence Investment Management

By Patrick Fearon-Hernandez, CFA, and Thomas Wash

[Posted: March 6, 2025 — 9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 closed down 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 2.3%. Chinese markets were higher, with the Shanghai Composite up 1.2% from its previous close and the Shenzhen Composite up 1.8%. US equity index futures are signaling a lower open.

With 491 companies having reported so far, S&P 500 earnings for Q4 are running at $65.50 per share compared to estimates of $64.79, which is up 11.7% from Q4 2023. Of the companies that have reported thus far, 74.6% have exceeded expectations, while 19.0% have fallen short of expectations.

The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below with new items of the day in bold:

Bi-Weekly Geopolitical Report	Asset Allocation Bi-Weekly	Asset Allocation Quarterly	Of Note
"Sanctions as an Investment Risk" (2/24/25) + podcast	"Tackling Long-Term Interest Rates" (3/3/25) + podcast	Q1 2025 Report Q1 2025 Rebalance Presentation	The Confluence of Ideas podcast Business Cycle Report

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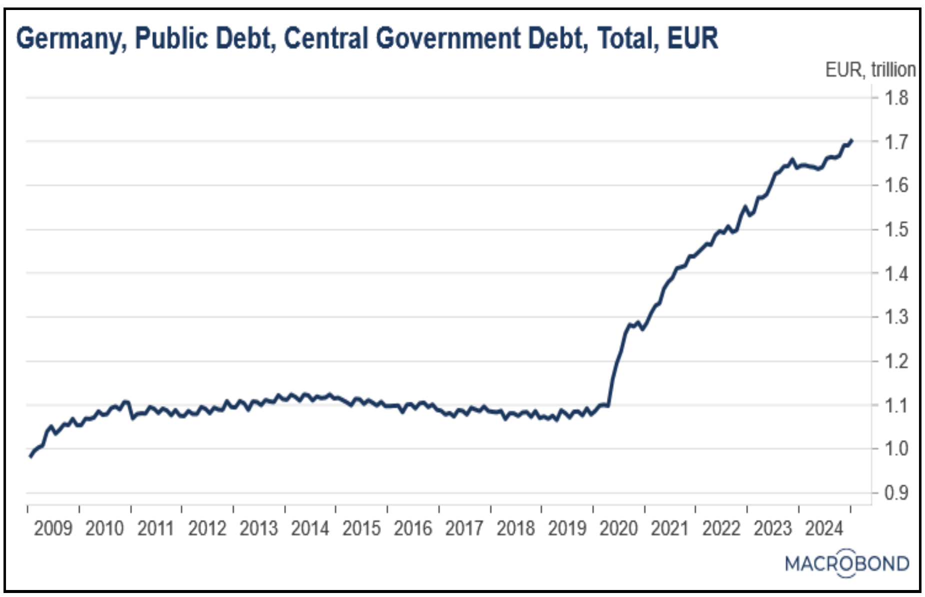
Good morning! The market is still digesting the latest economic data. In sports news, Ole Miss pulled off an upset victory over number four ranked Tennessee. Today's *Comment* will cover Europe's decision to ramp up defense spending, the challenges in assessing the current state of the US economy, and other market-related developments. As usual, the report will conclude with a roundup of domestic and international data releases.

Europe Arms Up: The EU has intensified discussions to strengthen its defense capabilities, as it no longer trusts that the US will honor its security commitments. This shift has triggered a surge in European bond yields, as the EU not only works to enhance its defense infrastructure but also revises its fiscal targets.

- EU leaders are convening an emergency summit in Brussels to talk about bolstering their defense capabilities in support of Ukraine. European officials will use the meeting to advance a series of new proposals aimed at enhancing the bloc's ability to allocate funds for defense. This move comes as Germany and France have taken more assertive steps to ensure their security in the event of a potential US withdrawal of support.

- Germany's incoming Chancellor Friedrich Merz has agreed to support expanding the country's fiscal limits to facilitate increased spending on defense and infrastructure. The new initiative is expected to allow for unlimited defense spending and establish a 500 billion EUR ($541 billion), 10-year fund to drive infrastructure investments. The increasing in spending is on a pace not seen since the fall of the Berlin Wall.
- However, the legislation still requires a two-thirds majority in parliament to become law, which could prove challenging given the reluctance of the far-right AfD and far-left parties — who collectively hold roughly 27% of seats — to support increased military spending. There is also likely to be some pushback from German lawmakers that are more fiscally conservative.
- In France, President Emmanuel Macron is advocating for the EU to consider how his country's nuclear weapons could serve as a deterrent against Russia. His comments follow a proposal from Merz, who has called for Germany, France, and the UK to develop their own nuclear sharing network as a potential alternative to relying on the US.

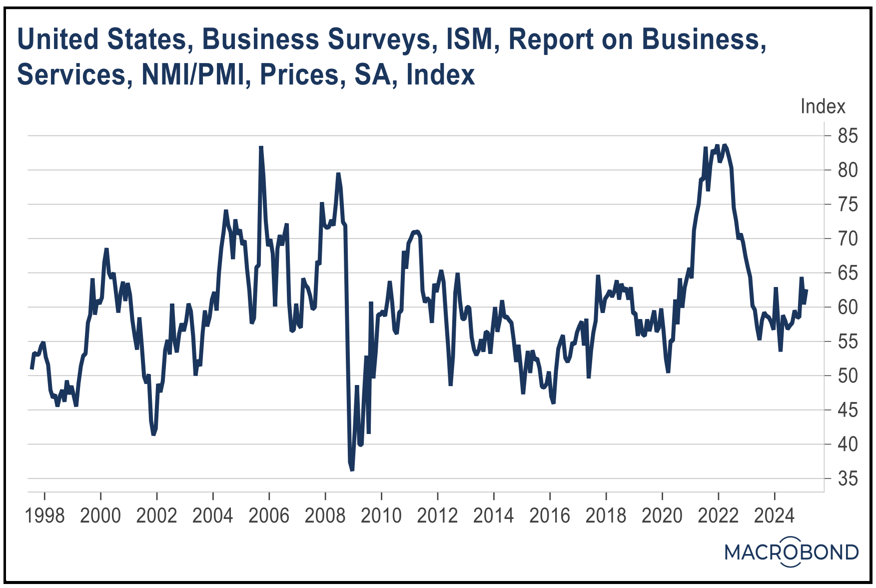


- The main takeaway from this shift in tone regarding defense spending across the EU is that member states will likely need to borrow significantly. One key development to watch is the potential creation of another joint European bond, similar to the one used to fund pandemic-related expenditures. This move could also bring the EU closer to forming a fiscal union, which would likely impact global bond markets and pose a challenge to the dominance of US Treasurys.

Mixed Economic Signals: A strong February PMI Services survey from the Institute for Supply Management (ISM) has bolstered optimism that the economy remains in expansion territory.

However, both the index and the Federal Reserve's Beige Book highlight growing concerns among firms about the potential for a downturn. These conflicting signals are likely to exacerbate ongoing market uncertainty.

- The ISM Services PMI unexpectedly rose from 52.8 to 53.5 in February, driven by a sharp increase in new orders, employment, and inventories. However, the report also highlighted growing inflationary pressures, as input prices surged to their highest level since early 2023. While the data has alleviated some concerns about an imminent downturn, it has raised fears of a potential reacceleration in inflation.
- The PMI report also highlighted that firms remain concerned about persistent uncertainty and the outlook for future business activity. Additionally, survey respondents expressed unease over potential deep cuts to government spending. The wariness has led to concern that economic activity could start to slow.
- The latest Federal Reserve Beige Book indicated that GDP growth may have improved slightly since mid-January, despite most regions not experiencing actual growth. The report revealed that eight out of twelve districts reported either no growth or a contraction during recent weeks. While some of this slowdown was attributed to adverse weather conditions, there were also reports of firms expressing concerns about rising prices.



- Currently, investors are closely monitoring economic data to assess the impact of tariffs and government spending on the economy. The market is likely to sell off at any sign of consumers cutting back on spending or firms laying off workers, while rallying in the opposite scenario. Although there are some indications that a downturn may be on the horizon, there is no conclusive evidence of one yet.

Steering with Open Ears: The president has decided to hold talks with business leaders as he aims to shape his agenda in a way that minimizes the impact on businesses. While these discussions may result in adjustments to some of his policies, a full reversal is unlikely.

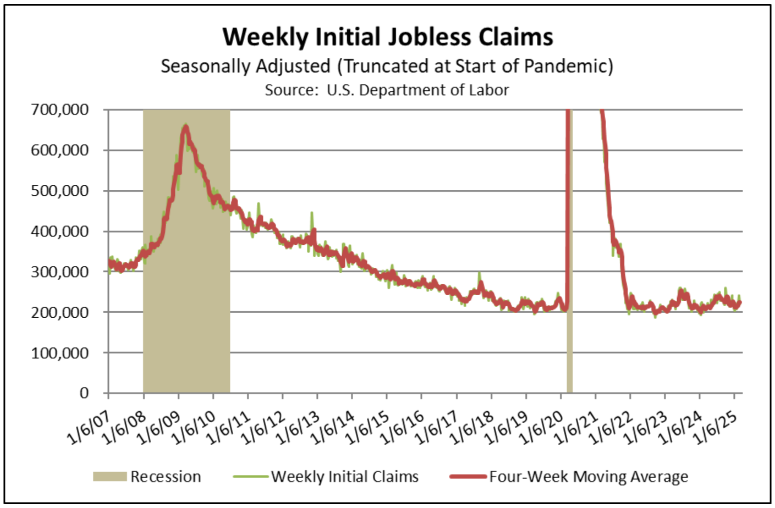
- The Trump administration has announced a one-month delay in tariffs on all goods eligible for duty-free treatment under the USMCA, a move specifically benefiting the auto industry. This exception follows intense lobbying from the sector, which warned that the import taxes could severely disrupt supply chains. Estimates suggest that the tariffs could increase the cost of a vehicle by approximately $10,000.
- Chipmakers and computer hardware developers also plan to visit the White House, as they have raised concerns about import and export restrictions. This move coincides with the president's broader shift in policy, which includes not only tariffs and export controls but also a move away from the previous administration's approach of fostering domestic industry through public investment. Instead, the focus is now on a strategy centered around foreign direct investment.
- While the administration has shown a willingness to compromise with tech leaders to prevent an economic slowdown, it appears unwilling to abandon some of its more controversial policies. This reluctance to compromise suggests that the president and his team may be aiming to drive significant changes in the country, for better or worse. At this stage, the situation remains highly fluid, with developments evolving rapidly. As a result, expect considerable volatility in the near term.

China's Response: Beijing appears to be better prepared to handle a trade war with the US compared to President Trump's first term, signaling that the trade tensions could persist for longer than many are expecting.

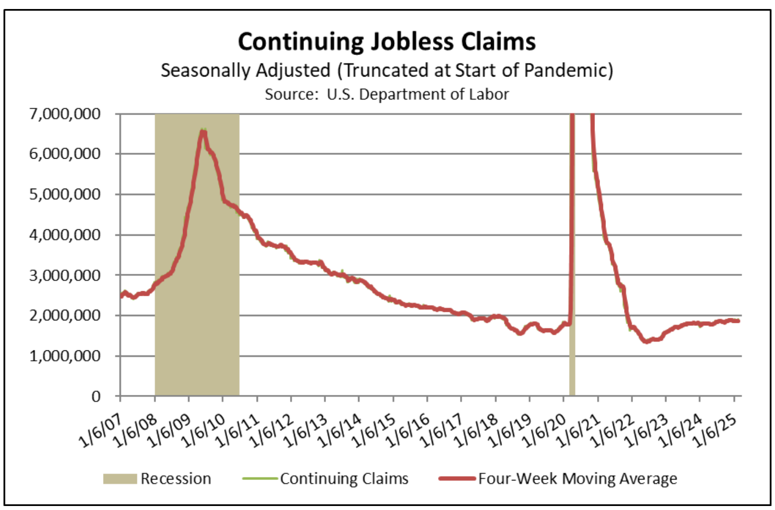
- The government plans to implement policy measures aimed at achieving its growth target of around 5% for 2025. These measures not only include further monetary policy accommodation, with the People's Bank of China expected to lower its policy rate and the reserve requirement ratio, but also include an increase in the fiscal deficit target to accommodate higher spending.
- In the meantime, businesses are struggling to compel their Chinese suppliers to absorb the majority of the tariff costs. For instance, Walmart has asked its suppliers in China to shoulder the full burden of the tariffs, only to face pushback, as such a move would force these companies to operate at a loss. This development suggests that American firms may have to absorb some of the costs themselves or pass them on to consumers.
- While we still believe the trade war is likely to exacerbate China's economic challenges, we are closely monitoring political developments within the region, as they could play a decisive role in Beijing's ability to manage escalating trade tensions with the US. That said, we remain confident that Beijing will strive to contain the trade war as much as possible, including pursuing a potential deal with the US.

US Economic Releases

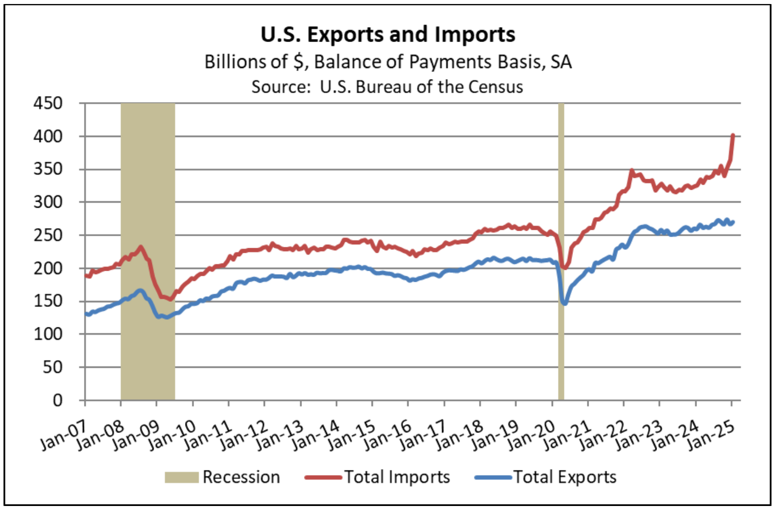
In the week ended March 1, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 221,000, below both the expected level of 233,000 and the previous week's level of 242,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 224,250, but it remains historically low. The chart below shows how initial jobless claims have fluctuated since just before the Great Financial Crisis. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



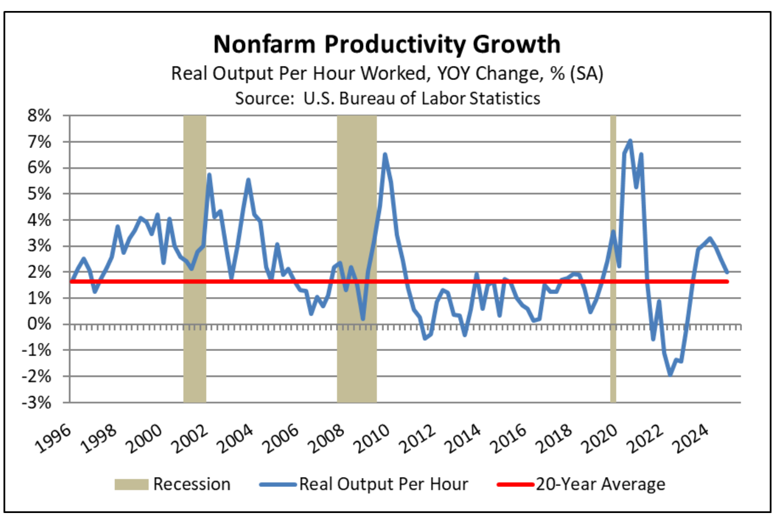
In the week ended February 22, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to a seasonally adjusted 1.897 million, above both the anticipated reading of 1.874 million and the prior week's revised reading of 1.855 million. The four-week moving average of continuing claims rose to 1.866 million, continuing to suggest that those who do lose their jobs are finding it more difficult to land a new one. The chart below shows how continuing claims have fluctuated since the GFC. It is also truncated during the pandemic period because of the high level of claims at the time.



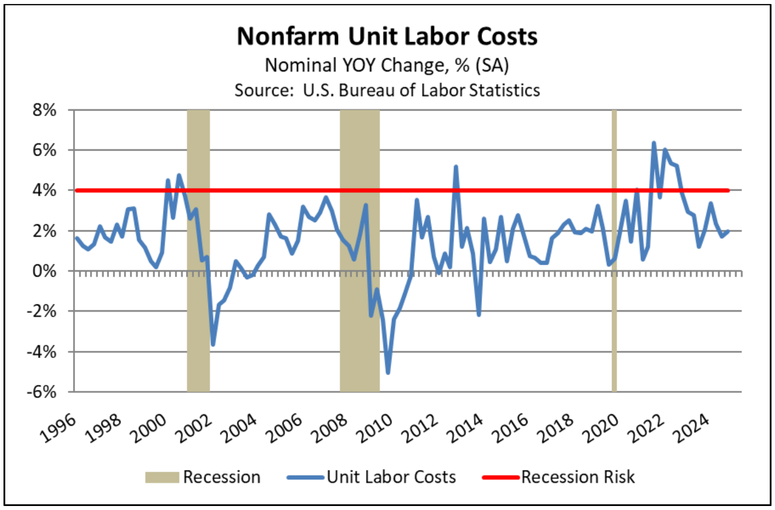
In a separate report today, the January ***trade balance*** showed a record seasonally adjusted deficit of $131.4 billion, wider than both the expected shortfall of $128.8 billion and the revised December shortfall of just $98.1 billion. According to the data, total ***exports*** rose 1.2%, while *imports* jumped 10.0%, probably reflecting companies pulling in foreign purchases early to get ahead of the Trump administration's tariffs. The jump in imports will weigh heavily on US gross domestic product for the first quarter, although it will likely be at least partially offset by any associated jump in inventories. In any case, compared with the same month one year earlier, exports in January were up 4.1%, while imports were up 23.1%. The chart below shows the monthly value of US exports and imports since just before the previous recession.



The last major report so far today focused on the productivity of US workers, defined as the average value of output per hour worked. After stripping out price changes and normal seasonal fluctuations, final fourth-quarter ***nonfarm productivity*** rose at an annualized rate of 1.5%, exceeding expectations that the growth rate would remain at the previous estimate of 1.2%. Taking into account the fluctuations in each of the last four quarters, productivity in the fourth quarter was up 2.0% from the same period one year earlier, beating the average annual increase of 1.6% over the last couple of decades. The chart below shows the year-over-year growth in real productivity over the last quarter-century or so.



Consistent with the better-than-expected productivity growth, fourth-quarter ***unit labor costs*** rose at an annualized rate of just 2.2%, compared with expectations that the growth rate would remain unchanged from the initial estimate of 3.0%. Like productivity, unit labor costs in the fourth quarter were also up 2.0% year-over-year, well below the 4.0% level that has sometimes been associated with recessions in the past. The chart below shows the year-over-year growth in unit labor costs since 1996.



The table below lists the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Wholesale Inventories	m/m	Jan F	7.0%	0.7%	**
10:00	Wholesale Trade Sales	m/m	Jan	0.5%	1.0%	*
Federal Reserve						
10:30	Patrick Harker Gives Speech on Economic Education	President of the Federal Reserve Bank of Philadelphia				
11:00	Christopher Waller Speaks on Economic Outlook	Member of the Board of Governors				
18:30	Raphael Bostic Speaks on Economy to Birmingham Business Journal	President of the Federal Reserve Bank of Atlanta				

Foreign Economic News

We monitor numerous global economic indicators on a continuous basis. The most significant international news that was released overnight is outlined below. Not all releases are equally significant, thus we have created a star rating to convey to our readers the importance of the various indicators. The rating column below is a three-star scale of importance, with one star being the least important and three stars being the most important. We note that these ratings do change over time as economic circumstances change. Additionally, for ease of reading, we have also color-coded the market impact section, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications, and green indicates neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	Japan Buying Foreign Bonds	w/w	28-Feb	¥1514.2	-¥197.0b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	28-Feb	¥626.9b	¥19.7b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	28-Feb	¥776.5b	¥436.0b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	28-Feb	-¥708.3b	-¥1038.0b		*	Equity and bond neutral
Australia	Building Approvals	m/m	Jan	6.3%	1.7%	0.0%	***	Equity and bond neutral
	Trade Balance	m/m	Jan	A$5620m	A$4924m	A$5900m	***	Equity and bond neutral
	Exports	m/m	Jan	1.3%	1.2%		*	Equity and bond neutral
	Imports	m/m	Jan	-0.3%	5.9%		*	Equity and bond neutral
South Korea	Foreign Reserves	m/m	Feb	$409.21b	$411.01b	--	**	Equity and bond neutral
	CPI	m/m	Feb	2.0%	2.2%	2.1%	***	Equity and bond neutral
EUROPE								
Eurozone	Retail Sales	y/y	Jan	1.5%	2.2%	2.0%	*	Equity bearish, bond bullish
Germany	HCOB Germany Construction PMI	m/m	Feb	41.2	42.5		*	Equity and bond neutral
UK	S&P Global UK Construction PMI	m/m	Feb	44.6	48.1	49.5	**	Equity and bond neutral
Switzerland	Unemployment Rate	m/m	Feb	2.9%	3.0%	2.9%	**	Equity and bond neutral
Russia	Retail Sales	m/m	Jan	5.4%	5.2%	4.7%	***	Equity bullish, bond bearish
	Unemployment Rate	m/m	Jan	2.40%	2.30%	2.30%	***	Equity and bond neutral
AMERICAS								
Canada	S&P Global Canada Services PMI	m/m	Feb F	46.6	49.0		*	Equity and bond neutral
	S&P Global Canada Composite PMI	m/m	Feb	46.8	49.5		*	Equity and bond neutral

Financial Markets

The table below highlights some of the indicators that we follow daily. Again, the color coding is similar to the foreign news description above. We will add a paragraph below if a certain move merits further explanation.

Fixed Income	Today	Prior	Change	Trend
3-mo T-bill yield (bps)	420	421	-1	Flat
U.S. Sibor/OIS spread (bps)	430	430	0	Down
U.S. Libor/OIS spread (bps)	430	431	-1	Down
10-yr T-note (%)	4.30	4.28	0.02	Up
Euribor/OIS spread (bps)	250	249	1	Down
Currencies	**Direction**			
Dollar	Up	US		Down
Euro	Down	Euro		Up
Yen	Up	Japan		Up
Pound	Down	UK		Up
Franc	Down	Switzerland		Down
Central Bank Action	**Current**	**Prior**	**Expected**	
ECB Deposit Facility Rate	2.50%	2.75%	2.50%	On Forecast
ECB Main Refinancing Rate	2.65%	2.90%	2.65%	On Forecast
ECB Marginal Lending Facility	2.90%	3.15%	2.90%	On Forecast

Commodity Markets

The commodity section below shows some of the commodity prices and their change from the prior trading day, with commentary on the cause of the change highlighted in the last column.

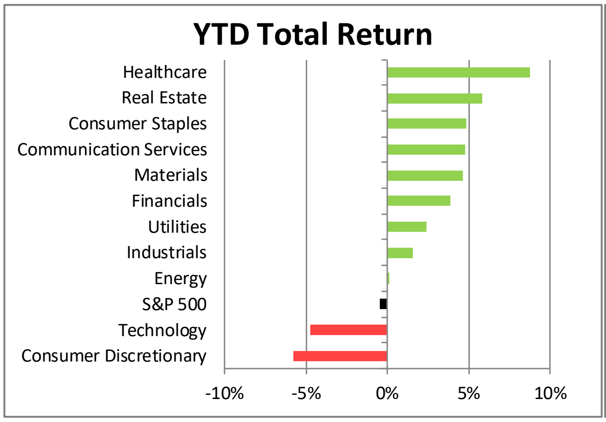
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$69.75	$69.30	0.65%	
WTI	$66.77	$66.31	0.69%	
Natural Gas	$4.41	$4.45	-0.85%	
Crack Spread	$24.80	$24.77	0.14%	
12-mo strip crack	$20.94	$20.87	0.35%	
Ethanol rack	$1.75	$1.75	0.18%	
Metals				
Gold	$2,901.52	$2,919.39	-0.61%	
Silver	$32.38	$32.66	-0.87%	
Copper contract	$477.80	$479.40	-0.33%	
Grains				
Corn contract	$457.75	$455.75	0.44%	
Wheat contract	$550.25	$548.25	0.36%	
Soybeans contract	$1,020.75	$1,011.75	0.89%	
Shipping				
Baltic Dry Freight	1,228	1,262	-34	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	3.61	0.80	2.81	
Gasoline (mb)	-1.43	-0.75	-0.68	
Distillates (mb)	-1.32	1.50	-2.82	
Refinery run rates (%)	-0.6%	0.45%	-1.1%	
Natural gas (bcf)		-94		

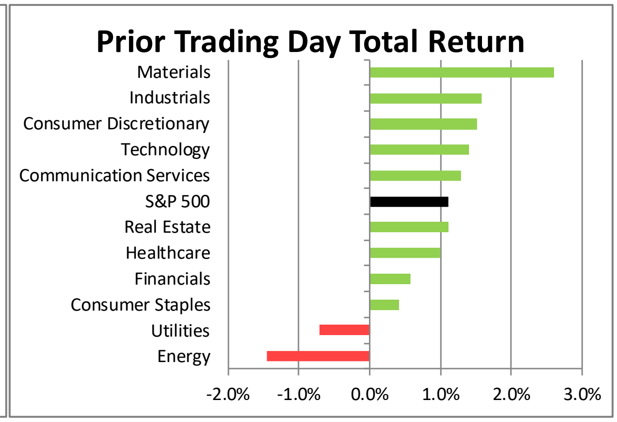
Weather

The 6-to-10 and 8-to-14-day forecasts call for cooler-than-normal temperatures along the West Coast, throughout the Rocky Mountain region, and in the northern Great Plains, with warmer-than-normal temperatures in almost all other areas. The forecasts call for wetter-than-normal conditions in all areas except for Texas and Florida. Conditions in Texas are expected to be drier than normal, while Florida's conditions will be near normal.

Data Section

US Equity Markets – (as of 3/5/2025 close)

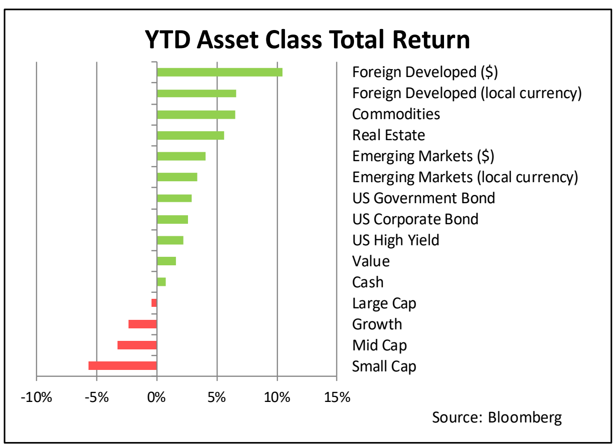




(Source: Bloomberg)

These S&P 500 and sector return charts are designed to provide the reader with an easy overview of the year-to-date and prior trading day total return. Sectors are ranked by total return; green indicating positive and red indicating negative return, along with the overall S&P 500 in black. These charts represent the new sectors following the 2018 sector reconfiguration.

Asset Class Performance – (as of 3/5/2025 close)

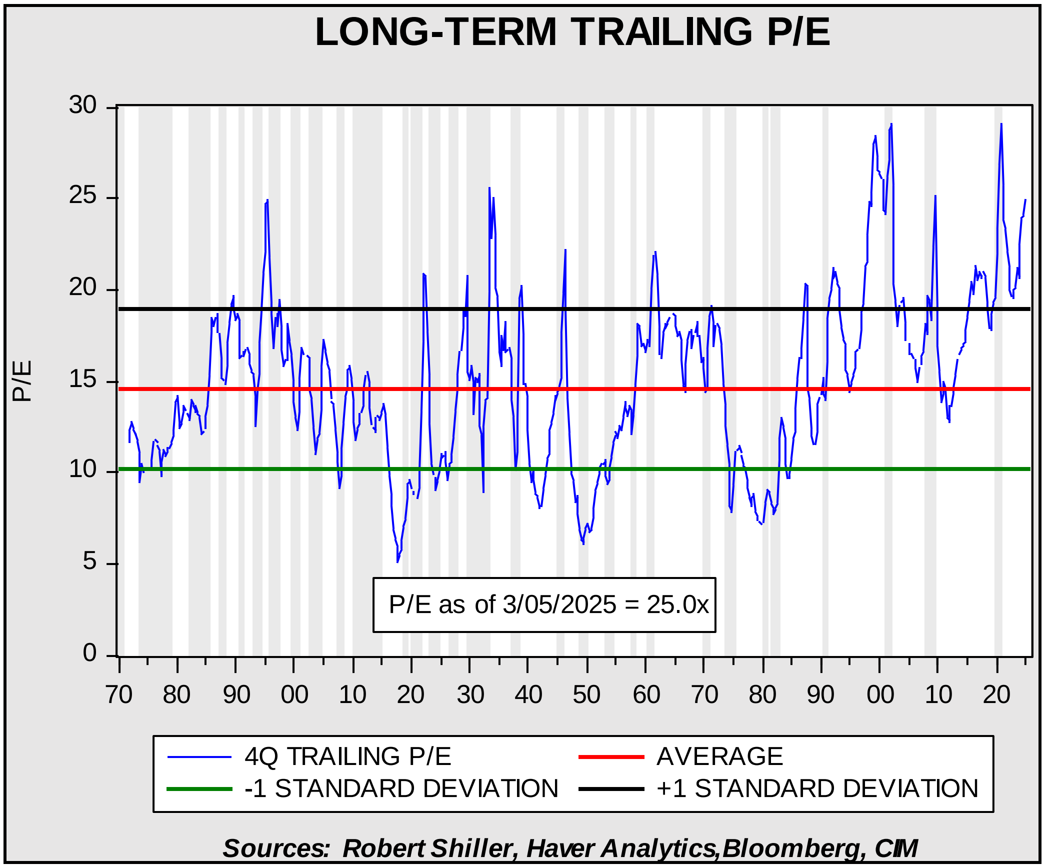


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

Asset classes are defined as follows: Large Cap (S&P 500 Index), Mid Cap (S&P 400 Index), Small Cap (Russell 2000 Index), Foreign Developed (MSCI EAFE (USD and local currency) Index), Real Estate (FTSE NAREIT Index), Emerging Markets (MSCI Emerging Markets (USD and local currency) Index), Cash (iShares Short Treasury Bond ETF), US Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), US Government Bond (iShares 7-10 Year Treasury Bond ETF), US High Yield (iShares iBoxx $ High Yield Corporate Bond ETF), Commodities (Bloomberg total return Commodity Index), Value (S&P 500 Value), Growth (S&P 500 Growth).

P/E Update

March 6, 2025



Based on our methodology,[1] the current P/E is 25.0x, down 0.1 from our last report. The drop in multiple was driven by a decline in the stock price index.

This report was prepared by Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change. This is not a solicitation or an offer to buy or sell any security.

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[1] This chart offers a running snapshot of the S&P 500 P/E in a long-term historical context. We are using a specific measurement process, similar to *Value Line*, which combines earnings estimates and actual data. We use an adjusted operating earnings number going back to 1870 (we adjust as-reported earnings to operating earnings through a regression process until 1988), and actual operating earnings after 1988. For the current quarter, we use the Bloomberg estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes three actual quarters (Q1, Q2, and Q3) and one estimate (Q4). We take the S&P average for the quarter and divide by the rolling four-quarter sum of earnings to calculate the P/E. This methodology isn't perfect (it will tend to inflate the P/E on a trailing basis and deflate it on a forward basis), but it will also smooth the data and avoid P/E volatility caused by unusual market activity (through the average price process). Why this process? Given the constraints of the long-term data series, this is the best way to create a long-term dataset for P/E ratios.